No. 94-2027 (5)

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1995

MONTGOMERY SECURITIES and PAINEWEBBER, INC.,

Petitioners,

v.

RICHARD B. DANNENBERG, MINDY BLITZ, EUGENE COSTIGLIO, KENNETH H. ROSS, HOMER FLEISHER, STEVEN G. COOPERMAN, NATHANIEL ORME, ERVIN H. FISHMAN, FREDERICK WERTHEIMER, BARBARA WERTHEIMER, WILLIAM J. BING, ARLENE S. BING, trustees of William J. Bing and Arlene S. Bing Living Trust, ANTHONY D. SHAPIRO, WILLIAM DULUDE, H.N. BROWN, JR., DAVID E. LOCKROW, KARL E. BAUMAN, LUCILLE C. BAUMAN, and JACK SCHNITZER, On Behalf of Themselves and all others Similarly Situated,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

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I. The Pressing Question of What Scienter Standard Applies Under Section 10(b) is Squarely Presented and is a Question That the Court Should Address.

Plaintiffs make four principal arguments why certiorari should not be granted on the question of what state of mind is required to impose liability in a private Section 10(b) claim. First, plaintiffs deny that there is any disarray among the lower courts as to the appropriate standard to apply. Opp. 8, 14-16. Second, even if there is such confusion, plaintiffs argue that the Court should not consider the question in this case, because the Ninth Circuit ostensibly found that the evidence was sufficient to support a finding not just of recklessness but of intentional fraud. Opp. 5, 6, 7-8, 10, 16. Third, plaintiffs argue that the question presented was not properly preserved below. Opp. 4, 7. Finally, plaintiffs assert that addressing the question is premature, either because Congress may enact legislation on the issue or because the case is at the summary judgment stage. Opp. 8, 14, 16-17.

For the reasons set forth below, none of these arguments provides grounds for denying certiorari.[1]

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[1] In their Opposition, plaintiffs also argued the merits, claiming that recklessness is sufficient to satisfy the mental state required under Section 10(b). *See* Opp. 11-14. Plaintiffs' analysis, however, requires only a limited response. To begin with, plaintiffs did not address the central issue, which is whether liability for recklessness is consistent with the language of Section 10(b), its legislative history, or the structure of the securities laws. Rather, their analysis is limited to the mental state required for common law fraud.

Even as to this point, plaintiffs simply repeat what this Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), and the Underwriters in their Petition, expressly recognized – namely, that recklessness was sufficient to prove fraud at common law "under some circumstances." *Id.* at 193 n.12; Pet. 12-13. The Underwriters showed in their Petition, however, and plaintiffs' own authorities confirm, that such "circumstances" were limited to *subjective* recklessness: the defendant had to know that it did not know whether the statement was true or false. Pet. 12-13; Opp. 12 n.4 (quoting *Lehigh Zinc & Iron Co. v. Bamford*, 150 U.S. 655, 673 (1893) (person must have been "conscious that he has no such knowledge")). The Ninth Circuit, however, does not require subjective knowledge to impose liability under Section 10(b). Its standard measures reasonableness, not dishonesty.

Plaintiffs attempt to slide over this critical distinction by arguing that subjective knowledge may sometimes be inferred from objective facts. Opp. 17-18. As the

1. Plaintiffs claim that it is "nonsense" to assert that there is any confusion among the lower courts on the scienter issue, and argue that the Courts of Appeals "uniformly" march to the same standard. Opp. 8, 14-16. In purporting to find such uniformity, however, plaintiffs stand alone. Unlike plaintiffs, commentators have found the caselaw in this area to be "largely incoherent,"[2] "too amorphous,"[3] "highly indeterminate,"[4] "deeply" split,[5] and "a veritable quagmire for the courts."[6] Unlike plaintiffs, the SEC likewise has found confusion and conflict among the circuits, and indeed has urged that all of the various standards utilized by the Courts of Appeals be rejected in favor of yet another approach.[7] And the courts themselves are acutely aware of the lack of coherence, even within the same Circuit. In *In re Leslie Fay Company Securities Litigation*, 835 F. Supp. 167, 172 & n.1 (S.D.N.Y. 1993), for example, the law within the Second Circuit is described as "indeed a murky area," with "confusion . . . so severe that it has resulted in conflicting opinions in the same case."

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seminal decision on deceit law observed more than a century ago, however, such an argument is fundamentally flawed: it involves "a confusion of unreasonableness of belief as evidence of dishonesty, and unreasonableness of belief as of itself a ground of action." *Derry v. Peek*, 14 App. Cas. 337, 352 (H.L. 1889) (Bramwell, L.). The common law required dishonesty, not merely unreasonableness, to sustain a cause. *Id.* This case squarely poses the question whether Section 10(b) liability can be imposed on a far lesser showing.

[2] Kevin R. Johnson, *Liability for Reckless Misrepresentations and Omissions Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. Cin. L. Rev. 667, 686 (1991).

[3] 2 Thomas Lee Hazen, *Treatise on the Law of Securities Regulation* 84 (2d ed. 1990).

[4] James D. Cox, et al., *Securities Regulation: Cases and Materials* 740 (1991).

[5] Marc I. Steinberg & Samuel H. Gruenbaum, *Variations of "Recklessness" After Hochfelder and Aaron*, 8 Sec. Reg. L. J. 179, 181 (1980).

[6] Paul S. Milich, *Securities Fraud Under Section 10(b) and Rule 10b-5: Scienter, Recklessness, and the Good Faith Defense*, 11 J. Corp. L. 179, 180 (1986).

[7] *See* Brief of *Amici Curiae* at 12-13 & n.29.

Nowhere is the need for guidance from this Court more painfully apparent, however, than in the Ninth Circuit's gyrations on the subject. For years, different panels have adopted a variety of contradictory standards, including some that the court itself has acknowledged are "not clearly distinguishable from negligence." *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (*en banc*) (citations omitted), *cert. denied*, 499 U.S. 976 (1991). The adoption in *Hollinger* of the standard from *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977), has not served to end the confusion. Indeed, the panel's adoption in this case of a negligence ("should have known") standard bears out the SEC's warning to the Ninth Circuit that *Sundstrand* is so ambiguous that it may be interpreted as requiring anything from mere negligence to heightened recklessness. *See* Brief *Amici Curiae* at 12 n.28.

In short, as one commentator summarized, "resolution of the availability of a recklessness standard, as well as a more explicit definition, must await Supreme Court determination." 2 Hazen, *supra* note 3, at 84. Until that time, it is likely that many courts, such as the Ninth Circuit here, will apply a standard "closer to negligence than the type of scienter that the Court in *Hochfelder* and *Aaron* might have had in mind." *Id.*

2. Even if there is confusion among the lower courts as to the proper standard to apply, plaintiffs contend that this is the wrong case in which to address the question, because the Ninth Circuit purportedly found the evidence against the Underwriters to be sufficient to support a finding of "deliberate fraud." Opp. 10. In making this argument, plaintiffs seemingly have fallen down a hole and emerged in a land where English words no longer have their ordinary meaning. Otherwise, the Court of Appeals could not have put its contrary conclusion any more plainly. It said with respect to the "only" Section 10(b) issues: "The plaintiffs presented *no* evidence of the Underwriters' actual knowledge or fraudulent intent on these issues." (A18) (emphasis added). The Court did not simply find that the evidence was insufficient – it found that there was not *any* evidence to support an inference of knowledge or deliberate fraud. That, of course, is what "no" means.

The Ninth Circuit's unambiguous conclusion is hardly surprising, inasmuch as plaintiffs did not even *claim* that the Underwriters had engaged in deliberate fraud, either in the district court or on appeal. In the district court, plaintiffs argued that the Underwriters had "actual knowledge" that "preliminary financial data was *available* for the June quarter" (emphasis added), but not that they had *seen* the information – only that they "should have" been suspicious and investigated further. (A40-41). Similarly, on appeal, plaintiffs asserted that "the accountants knew of the fraud,"[8] but only that the Underwriters should have known of it.[9]

The Ninth Circuit accepted plaintiffs' argument: it found that a reasonable jury could infer that the Underwriters "knew that Toolworks' financial data actually was available," "had access to" (not "had seen") this preliminary data, and therefore "knew, or should have known" of the alleged fraud.[10] (A15-16). The court did not, however, go on to find a supportable inference of deliberate fraud. Indeed, to do so would have been hopelessly inconsistent with the remainder of the court's opinion. For example, while finding a triable issue as to the Underwriters' diligence in investigating the preliminary June data, the court simultaneously found that the Underwriters were so diligent in investigating media allegations in June of slumping sales and improper accounting practices that no reasonable jury could find them even to have been negligent. (A14). Obviously, no one with an intent to defraud would

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[8] Appellants' Ninth Circuit Opening Brief at 18.

[9] "The underwriters, knowing that preliminary data for the crucial June quarter were available, did not ask for them, and made no effort to verify Toolworks' optimistic estimates to the SEC and the investing public. Instead, they blindly relied on management assurances." *Id.*

[10] Similarly, the "truth" that the Underwriters ostensibly might have helped to "conceal" was "that Toolworks' financial data actually was available." Because these results were themselves "optimistic," *id.*, plaintiffs have never suggested that their purported concealment would have assisted the fraud. Rather, plaintiffs' theory, which the Ninth Circuit's decision mirrors, is that if the Underwriters had attempted to verify these optimistic results, the fraud would have come to light. The complaint against the Underwriters thus is not that they were participants in the fraud, but that they should have uncovered it.

simultaneously pursue a diligent investigation that might well have revealed the fraud to others. The Ninth Circuit did not attempt to resolve this patent contradiction, but then it did not have to: it already had found "no evidence" of the Underwriters' knowledge or intent. (A18).

Finally, if the Ninth Circuit had held that the circumstances could support an inference of deliberate fraud, it would only have served to sharpen the conflict among the lower courts. Indeed, as the Underwriters showed in the Petition, courts have rejected even an inference of recklessness – much less deliberate fraud – on facts far stronger than those involved here. Thus, for example, in *McLean v. Alexander*, 599 F.2d 1190 (3d Cir. 1979), the court held that a factfinder might determine that inconsistencies in documents actually reviewed by (not just "available" to) the auditors "should have" led them to "ma[ke] further inquiry." Section 10(b) liability could not be imposed on such a basis, however, because it amounted to a theory of mere "negligence, which *Hochfelder* found insufficient."[11] *Id.* at 1200. In holding that a failure to investigate does support a Section 10(b) claim, the Ninth Circuit's conflict with other courts is clear, but understandable: as noted above, the Ninth Circuit in effect applies a negligence standard,[12] and hence it is not surprising that it would impose liability on this theory. To go yet further, and hold that these facts could show knowledge or intent, would exacerbate, not mitigate, the conflict on this question.

3. Plaintiffs next object that the Underwriters have not properly preserved the question presented. Plaintiffs' objection is not valid. To begin with, the Underwriters did in fact preserve the issues that are framed in the question. As noted previously, the Ninth Circuit addressed the scienter question *en banc* in *Hollinger*, and held that recklessness was sufficient under Section 10(b). *See* 914 F.2d at 1568-69. Because the panel was powerless to deviate from this *en banc* holding, the

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[11] *Accord* cases cited in Pet. 19-20 & n.16.

[12] *See, e.g., Krim v. BancTexas Group, Inc.*, 989 F.2d 1435, 1449 (5th Cir. 1993) ("Insofar as Krim complains that 'BTX should have known' . . . he is claiming negligence").

Underwriters did not challenge this determination at the panel level. The Underwriters did, however, explicitly raise the issue of what form of recklessness should be required. Thus, the Underwriters urged the panel to follow *SEC v. Steadman*, 967 F.2d 636, 642 (D.C. Cir. 1992), and adopt a recklessness standard that requires a "lesser form of intent," rather than one that amounts to "mere negligence."[13] Brief for the Underwriter Appellees at 46.

In seeking rehearing of the panel's decision *en banc*, the Underwriters challenged the definition of recklessness adopted by the panel, *see* Underwriter Appellees' Petition for Rehearing and Suggestion for Rehearing *En Banc* at 5-11, and also raised the issue whether recklessness of any type is sufficient to impose liability under Section 10(b). On the latter point, the Underwriters argued that, under *Hochfelder*, "the existence of fraudulent intent is essential to a finding of liability under Rule 10b-5." *Id.* at 5. Given the panel's finding of no "actual knowledge or fraudulent intent," the Underwriters argued that the Section 10(b) claim had to be dismissed. *Id.* The question whether actual knowledge or intent, rather than mere recklessness, is required for liability under Section 10(b), thus was squarely before the Ninth Circuit.

Not only was the issue thus properly raised below, but policy considerations further support accepting review of the question presented. In *Virginia Bankshares, Inc. v. Sandberg*, 501 U.S. 1083, 1099 n.8 (1991), in deciding whether to consider an issue assertedly not raised below, the Court held that it is relevant to consider whether an issue is "in a state of evolving definition and uncertainty, and one of importance to the administration of federal law." (Citations omitted.) *Cf. Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 114 S. Ct. 1439 (1994) (resolving question of aiding and abetting liability after directing parties to address

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[13] The question was not only raised but passed upon by the panel. In rejecting the district court's conclusion that "should have" is "not the standard" required to show recklessness (A41), the Ninth Circuit specifically held that "knew, or should have known" is "sufficient to defeat summary judgment on the scienter issue." (A18).

issue). Here, both the uncertainty on the question and its importance are readily apparent. Section 10(b) litigation "demands certainty and predictability," *Id.* at 1454 (quoting *Pinter v. Dahl*, 486 U.S. 622, 652 (1988)), and the uncertainty of the governing rules, together with what this Court long has recognized as the unique danger of vexatiousness posed by such litigation, strongly support the grant of certiorari here.

4. Finally, plaintiffs' argue that the question is premature, either because Congress may legislate in the area, or because the case arises from a motion for summary judgment. Neither contention provides a persuasive basis for denying the Petition.

With respect to the possibility of a statutory amendment to Section 10(b), experience suggests that the likelihood that Congress will amend the statute to provide a definition of scienter is remote. Indeed, in the nearly half-century that Section 10(b) has been found to provide a private right of action, Congress repeatedly has amended the securities laws without addressing what mental state is required to establish a Section 10(b) violation.[14] If, as seems likely, past is prologue, this legislative session likewise will end without any legislative definition of Section 10(b) scienter. Given the importance of the scienter question to those who participate in the country's capital markets, and the uncertainty and unpredictability of the present rules for determining liability, surely fifty years of waiting for Congress to act is enough, and securities professionals, companies, and their investors are entitled to a definitive resolution of the scienter question.[15]

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[14] As plaintiffs correctly point out, the House recently passed a bill that would provide a definition of Section 10(b) scienter. *See* H.R. 1058, 104th Cong., 1st Sess. § 4 (1995) (Mar. 12, 1995). Legislation enacted by the Senate, however, specifically avoids providing any definition of the mental state required to make out a Section 10(b) violation. *See* S. 240, 104th Cong., 1st Sess. § 104(b) (June 28, 1995).

[15] As *Amici curiae* pointed out in their supporting brief, even if Congress were to enact legislation, there are hundreds of cases presently pending (and involving billions of dollars of potential liability) that would not be reached by such legislation. *See* Brief of *Amici Curiae* at 4 n.3.

Finally, the procedural posture of the case counsels in favor of, rather than against, the granting of the Underwriters' Petition. Because this case arises on a motion for summary judgment, there are no factual questions that might prevent the Court from reaching the purely legal question of what scienter standard should be adopted.[16] Nor is the question peripheral to the resolution of this litigation. To the contrary, because the Ninth Circuit has found no evidence of the Underwriters' actual knowledge or intent, a trial is unnecessary unless recklessness is enough. Similarly, if the Court finds that recklessness suffices under Section 10(b), but adopts a subjective standard, the claim against the Underwriters would have to be dismissed, or at a minimum remanded for consideration by the Ninth Circuit under the higher standard.[17]

II. The Second Question Also Merits the Court's Review.

It is a measure of the weakness of plaintiffs' opposition to a grant of certiorari on the second question that their brief is devoted almost entirely to an issue that the Ninth Circuit did not reach, and that this case accordingly does not raise. Plaintiffs' opposition, which goes so far as to rewrite not just the Ninth Circuit's decision but even the Underwriters' Question Presented, thus warrants only an abbreviated response.[18]

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[16] Indeed, the Court recently used a case in which the lower court had granted summary judgment to resolve the analogous issue in civil rights litigation of what mental state is required to show "deliberate indifference." *See Farmer v. Brennan*, 114 S. Ct. 1970, 1973 (1994).

[17] Plaintiffs' argument that subjective recklessness or knowledge always can be inferred from objective circumstances (Opp. 16-18) proves far too much, and taken to its logical conclusion would preclude the granting of a motion to dismiss or for summary judgment. In fact, however, cases often are disposed of by motion for failure to plead or prove facts that could sustain an inference of scienter. *See, e.g., Shields v. Citytrust Bancorp*, 25 F.3d 1124, 1128 (2d Cir. 1994) (affirming dismissal for failure to strong inference of scienter); *Krim v. BancTexas Group, Inc.*, 989 F.2d 1435, 1449-50 (5th Cir. 1993) (affirming summary judgment on scienter).

[18] The Underwriters have challenged the Ninth Circuit's reversal of the entry of summary judgment on both plaintiffs' Section 11 and Section 12(2) claims. *See* Pet. i. Plaintiffs have rewritten the question to apply only to Section 11. *See* Opp. i.

Section 11 and Section 12(2), both of which plaintiffs alleged as the basis for claims against the Underwriters, prohibit the use of statements that are rendered misleading by the omission of a material fact. Section 11, as the Underwriters pointed out in their Petition, also prohibits the omission of a material fact "required to be stated." (Pet. 24 n.19) Section 12(2), however, contains no such provision. Whether an omitted fact was "required to be stated," therefore, provides no basis for avoiding summary judgment on a Section 12(2) claim. The only basis for sustaining an "omission" theory under Section 12(2) is that it rendered misleading some affirmative statement that was made.

In its decision, the Ninth Circuit addressed plaintiffs' Section 11 and Section 12(2) claims together, from the first sentence of its analysis ("[w]e first address the plaintiffs' claims against the Underwriters under Sections 11 and 12(2) of the 1933 Act"), to the last ("[w]e remand for a trial on the merits of those [Section 11 and 12(2)] claims"). (A4, A16) Given its combined treatment, the Ninth Circuit's analysis, not surprisingly, was directed exclusively at the theory that would sustain liability under both statutes, namely, the omission of facts that would render a statement misleading. The Ninth Circuit was explicit on the point. In rejecting the Underwriters' argument that post-prospectus events could not provide a basis for liability, the court stated:

> The Underwriters' contention that the events of this period are inapplicable to Sections 11 and 12(2) liability is clearly incorrect. *Both statutory provisions* require disclosure of information needed in order to make a prospectus truthful and not misleading.

(A13 n.2) (emphasis added).

Contrary to plaintiffs' assertions, the decision thus was plainly based on the ground applicable to "both" statutory provisions. Plaintiffs' "required facts" argument, to which plaintiffs devote the great bulk of their opposition, *see* Opp. 18-21, was never reached by the Ninth Circuit. At most it would provide a basis for remanding the Section 11 claim to the Ninth Circuit after reversal, so that the Ninth Circuit could

decide, in the first instance, whether to follow the district court decisions which have rejected plaintiffs' "required facts" theory under Item 303 of SEC Regulation S-K.[19]

As to that issue, plaintiffs have virtually nothing to say. Plaintiffs fail effectively to rebut the Underwriters' showing that the Ninth Circuit's decision is in conflict with the text of Section 11 and Section 12(2), with their legislative history, and with the decisions of other lower courts both under the 1933 and 1934 Acts. They also pass over in silence what the Underwriters demonstrated would be the potentially severe chilling effect of the Ninth Circuit's rule on the ability of companies to engage in public offerings for several months out of each year. Plaintiffs' sole argument is to engage in a *reductum ad absurdum* of the language of both Sections 11 and 12(2), by which their requirement of an affirmative "statement" that the omission renders misleading effectively is written out of the statute books.

CONCLUSION

For all of these reasons, certiorari should be granted.

Respectfully submitted,

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[19] *In re Lyondell Petrochemical Co. Sec. Litig.*, 984 F.2d 1050, 1053 (9th Cir. 1993) (alleged failure to comply with Item 303 is not § 11 violation); *Anderson v. Clow*, [1993 Tr. Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,807, at 97,989 (S.D. Cal. Sept. 17, 1993) (Item 303(a) applies only to reports filed on Form 10-K, and "omitting Item 303(a) information from a Prospectus does not violate § 11").